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Proposed statement on auditing standards : The independent auditor's responsibility for the detection of errors or irregularities;Independent auditor's responsibility for the detection of errors or irregularities; Exposure draft (American Institute of Certified Public Accountants), 1976, April 30

American Institute of Certified Public Accountants. Auditing Standards Executive Committee

EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS: THE INDEPENDENT AUDITOR'S RESPONSIBILITY FOR THE DETECTION OF ERRORS OR IRREGULARITIES

APRIL 30, 1976

Issued by the Auditing Standards Executive Committee of the
American Institute of Certified Public Accountants
For Comment From Persons Interested in Auditing and Reporting

Comments should be received by July 30, 1976, and addressed to
Auditing Standards Division, File Ref. No. 4270
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036

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April 30, 1976

To Practice Offices of CPA Firms; Members of Council; Technical Committee Chairmen; State Society and Chapter Presidents, Directors and Committee Chairmen; Organizations Concerned With Regulatory, Supervisory or Other Public Disclosure of Financial Activities; Persons Who Have Requested Copies:

An exposure draft of a proposed Statement on Auditing Standards entitled "The Independent Auditor's Responsibility for the Detection of Errors or Irregularities" accompanies this letter. The exposure period has been extended in recognition of the importance of this issue.

This proposed Statement clarifies the auditor's responsibility for detecting errors or irregularities in an examination of financial statements in accordance with generally accepted auditing standards. It specifies that an independent auditor should plan his examination to search for errors or irregularities that would have a material effect on the financial statements.

The proposed Statement also recognizes that an audit provides reasonable, but not absolute, assurance that financial statements are not materially affected by errors or irregularities. The concept of reasonable assurance is discussed and definitions of the terms errors and irregularities are given.

Comments and suggestions on any aspect of the enclosed draft are sought and will be appreciated. They should be addressed to the Auditing Standards Division, File Ref. No. 4270, at the AICPA in time to be received by July 30, 1976. The Auditing Standards Executive Committee will be particularly interested in the reasoning underlying comments and suggestions.

Sincerely,

John F. Mullarkey

John F. Mullarkey, Director
Auditing Standards Division

Kenneth P. Johnson

Kenneth P. Johnson, Chairman
Auditing Standards Division

PROPOSED STATEMENT ON AUDITING STANDARDS

THE INDEPENDENT AUDITOR'S RESPONSIBILITY FOR THE DETECTION OF ERRORS OR IRREGULARITIES

(Supersedes Statement on Auditing Standards No. 1, section 110.05-.09)

1. This Statement provides guidance on the independent auditor's responsibility for detecting errors or irregularities when making an examination of financial statements in accordance with generally accepted auditing standards.

2. The term *errors* refers to unintentional mistakes in financial statements and includes mathematical or clerical mistakes, mistakes in the application of accounting principles, and oversight or misinterpretation of facts that existed at the time the financial statements were prepared.

3. The term *irregularities* refers to intentional distortions of financial statements, such as deliberate misrepresentations by management, sometimes referred to as management fraud, or misappropriations of assets, sometimes referred to as defalcations.[1] Irregularities in financial statements may result from the misrepresentation or omission of the effects of events or transactions; manipulation, falsification, or alteration of records or documents; omission of significant information from records or documents; recording of transactions without substance; intentional misapplication of accounting principles; or misappropriation of assets for the benefit of management, employees, or third parties. Such acts may be accompanied by the use of false or misleading records or documents and may involve one or more individuals among management, employees, or third parties.

Objective of the Auditor's Examination

4. The independent auditor's objective in making an examination of financial statements in accordance with generally accepted auditing standards is to form an opinion as to whether the financial statements present fairly financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles consistently applied. Generally accepted auditing standards require the independent auditor to plan his examination to search for errors or irregularities that would have a material effect on the financial statements and to exercise due skill and care in the conduct of that examination. Generally accepted auditing standards do not require the independent auditor to plan his examination to search for errors or irregularities that would not have a material effect on the financial statements.

Relationship of Independent Audits to Other Business Controls

5. Generally, entities operate with certain controls. Examples of controls for business entities include legal requirements, the monitoring of management activities by boards of directors and their audit committees, the internal audit function, and internal control procedures. Those who rely on financial statements look to those controls and to independent audits for a degree of assurance that material errors or irregularities will be prevented or, if they occur, detected within a timely period.

6. Independent audits provide reasonable, but not absolute, assurance that financial statements are not materially affected by errors or irregularities. The concept of reasonable assurance recognizes that, as with certain business controls, the costs of audits should bear a reasonable relationship to the benefits expected to be derived. As a result, the concept of testing has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on financial statements.

The Auditor's Approach to an Examination

7. The independent auditor's approach when making an examination in accordance with generally accepted auditing standards is influenced by the possibility of errors or irregularities in the circumstances, his judgment concerning the integrity of management, and the relationship between internal control and the potential for errors or irregularities.

8. *Possibility of Errors or Irregularities in the Circumstances.* The auditor should plan and perform an examination of financial statements with an attitude of professional skepticism and should recognize that the application of many of his customary auditing procedures may produce evidence of errors or possible irregularities. For example, the following circumstances, if not reasonably explained, may lead the auditor to question further whether errors or possible irregularities exist: (a) discrepancies within the accounting records, such as a difference between a control account and its supporting subsidiary records; (b) differences disclosed by confirmations; (c) significantly fewer responses to confirmation requests than expected; (d) transactions not supported by proper documentation; (e) transactions not recorded in accordance with management's general or specific authorization; or (f) the com-

[1] For guidance on other actions that an independent auditor should consider with respect to the possible illegality of such acts, see SAS No. XX, "Illegal Acts By Clients."

pletion of large, unusual, or complex transactions at or near year end.

9. Certain acts, such as collusion between client personnel and third parties or among management or employees of the client, may result in misrepresentations' being made to the auditor or in the presentation to the auditor of falsified records or documents that appear truthful and genuine. Examples of corroborative evidential matter that is normally accepted by the auditor are (a) certain representations by management concerning the completeness of the accounting records or the minutes of the board of directors' meetings and (b) documents containing representations from third parties, such as confirmations of accounts receivable by debtors and accounts payable by creditors, and confirmations and other documents received from banks or other depositories. An auditor cannot practically extend auditing procedures to confirm the truthfulness of all representations and to test the validity of all records or documents that are presented to him during his examination. Consequently, in the absence of evidence raising questions as to the truthfulness of a representation or the validity of a record or document, the auditor's reliance on it is reasonable. Further, auditing procedures cannot detect unrecorded transactions unless the auditor finds some evidence of their existence. An auditor ordinarily would have no means of detecting a failure to record, for example, the receipt of cash from a miscellaneous source or an omission from the accounting records of a payable to a new supplier.

10. *Integrity of Management.* The auditor should recognize that management can direct subordinates to record or conceal transactions in a manner that could result in a material misstatement of the financial statements. Thus, management can perpetrate irregularities by overriding controls that would prevent similar irregularities by other employees. Consequently, the auditor should be aware of the importance of management's integrity to the effective operation of internal control procedures.

11. The extent to which the auditor considers it necessary to corroborate information and representations obtained from management is a matter of judgment. In making that judgment, the auditor should consider whether there are circumstances that might predispose management to misstate financial statements. Such circumstances might include those of a company that is in an industry experiencing a large number of business failures, that lacks sufficient working capital or credit to continue operations, or that is preoccupied with maintaining a favorable earnings trend to the apparent exclusion of business realities.

12. The auditor should consider the possibility that management may have made material misrepresentations or may have overridden control procedures. He should evaluate these risks by considering factors such as the nature of the entity being audited, the susceptibility to irregularities of the item or transaction being examined, the degree of authority vested at various management levels, and prior experience with the client. For example, the following circumstances relating to the structure of a client's organization, although not necessarily indicative of the presence of irregularities, may cause the auditor to be concerned about the possibility that management may have made material misrepresentations or overridden internal control procedures: (a) operating management appears to have little regard for the need to establish and follow internal control procedures; (b) the company needs, but lacks, an internal audit staff; (c) key financial positions, such as controller, have a high turnover rate; or (d) the accounting and financial functions appear to be understaffed, resulting in a constant crisis condition and related loss of controls. However, obtaining more than reasonable satisfaction that management has not made material misrepresentations or has not overridden control procedures is not possible.

13. *Relationship Between Internal Control and the Potential for Errors or Irregularities.* Management is responsible for establishing and maintaining internal control procedures, including appropriate supervisory review procedures to encourage adherence to adopted policies and prescribed procedures and to identify errors and irregularities. This responsibility requires an awareness of the various types of errors and irregularities that may arise in the company's financial and reporting system and of the possible effects of such errors or irregularities on the financial statements.

14. Providing reasonable assurance that errors and irregularities in financial statements will be prevented or detected within a timely period is a function of internal control. SAS No. 1, section 320.65–.66, suggests the following approach to the auditor's evaluation of that function:

> A conceptually logical approach to the auditor's evaluation of accounting control, which focuses directly on the purpose of preventing or detecting material errors and irregularities in financial statements, is to apply the following steps in considering each significant class of transactions and related assets involved in the audit:
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> a. Consider the types of errors and irregularities that could occur.
> b. Determine the accounting control procedures that should prevent or detect such errors and irregularities.
> c. Determine whether the necessary procedures are prescribed and are being followed satisfactorily.
> d. Evaluate any weaknesses—i.e., types of potential errors and irregularities not covered by existing control procedures—to determine their effect on (1) the nature, timing, or extent of auditing procedures to be applied and (2) suggestions to be made to the client.
>
> In the practical application of the foregoing approach, the first two steps are performed primarily through the development of questionnaires, checklists, instructions, or similar generalized material used by the auditor. However, professional judgment is required in interpreting, adapting, or expanding such generalized material as appropriate in particular situations. The third step is accomplished through the review of the system and tests

of compliance and the final step through the exercise of professional judgment in evaluating the information obtained in the preceding steps.

In the development of questionnaires and checklists, the auditor uses accumulated experience and understanding of the points of risk for probable errors and irregularities. Irregularities commonly involve manipulation of particular aspects of the financial operations of a company or at certain times—for example, unusual entries in the cash account at or near a balance sheet date that affect the amount of cash presented.

15. Effective internal control reduces the probability that errors or irregularities will occur, but does not eliminate the possibility that they can occur. There are inherent limitations that should be recognized in considering the potential effectiveness of internal accounting control procedures (see SAS No. 1, section 320.34). Further, whether the objectives of accounting control will be achieved depends in substantial part on the competence and integrity of company personnel (see SAS No. 1, section 320.35). Consequently, the auditor does not place complete reliance on internal control. SAS No. 1, section 320.71, states in part:

> The second standard [of field work] does not contemplate that the auditor will place complete reliance on internal control to the exclusion of other auditing procedures with respect to material amounts in the financial statements.

Thus, the auditor's examination normally includes procedures to test for the existence of errors or irregularities that could occur and have a material effect on the financial statements even in the absence of material weaknesses[2] in internal control.

Procedures When Circumstances Indicate Possible Errors or Irregularities

16. If the independent auditor's examination reveals circumstances that cause him to believe that material errors or irregularities may exist, he should consider their implications and discuss the matter and the extent of any further investigation with appropriate levels of management, including, when advisable in his judgment, the board of directors or its audit committee. If senior members of management appear to be involved in irregularities, the board of directors or its audit committee should be informed. Also, if the auditor believes that material errors or irregularities may exist, he should attempt to obtain sufficient evidential matter to determine whether in fact they may have occurred and, if so, their effect. In this regard, the auditor may wish to consult with legal counsel on matters concerning questions of law. If practicable, the auditor should extend the scope of his examination in an effort to obtain such evidential matter. In some circumstances, however, it may be impracticable or impossible to obtain sufficient evidential matter to determine the possible existence of, or related effect of, material errors or irregularities, or the client may impose a limitation on the scope of the auditor's search for the evidential matter needed to reach a conclusion. If for any reason the auditor remains uncertain as to whether there are errors or irregularities that may materially affect the financial statements, he should consider qualifying his opinion or disclaiming an opinion on the financial statement or, depending on the circumstances, withdrawing from the engagement, indicating his reasons and findings in writing to the board of directors.

17. The independent auditor's examination may reveal possible errors or irregularities that he concludes could not be so material as to affect the financial statements he is examining. For example, irregularities involving peculations from a small imprest fund would normally be of little significance because both the manner of operating the fund and its size would tend to establish a limitation on the amount of a loss. The auditor should refer such matters to a representative of the client who appears to be at least one level above those involved, with the recommendation that the matter be pursued to a conclusion. The auditor should consider the effect of any immaterial irregularities, and the personnel involved, as it may relate to other aspects of his examination.

The Auditor's Responsibility to Detect Errors or Irregularities

18. An independent auditor's standard report expresses his opinion that the financial statements are presented fairly in conformity with generally accepted accounting principles, and implicitly indicates that, in his judgment, the statements taken as a whole are not materially misstated as a result of errors or irregularities. In reaching that judgment, the auditor's responsibility is to exercise due skill and care in the planning and conduct of his examination. However, identifying irregularities resulting from collusion, forgery, or certain unrecorded transactions ordinarily is not practicable for the auditor. Reasonable reliance on the client's accounting records ordinarily is warranted and unavoidable. Also, the auditor's resources for obtaining information, and his authority for that purpose, are significantly less than those of a law enforcement or regulatory agency conducting an investigation. In view of those and other limitations on the effectiveness of auditing procedures, an audit cannot be expected to provide absolute assurance that the financial statements are not materially affected by errors or irregularities. Thus, the subsequent discovery that errors or irregularities existed during the period covered by the independent auditor's examination does not, in itself, indicate inadequate performance on his part. If the auditor's examination was made in accordance with generally accepted auditing standards, he has fulfilled his professional responsibility.

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[2] SAS No. 1, section 320.68, defines a material weakness as follows:

> . . . a condition in which the auditor believes the prescribed procedures or the degree of compliance with them does not provide reasonable assurance that errors or irregularities in amounts that would be material in the financial statements being audited would be prevented or detected within a timely period by employees in the normal course of performing their assigned functions.